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Memorandum

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to: Bernard Nelson, Area Counsel
Natural Resources & Construction
(Large & Mid-Size Business)

from: Curtis G. Wilson
Associate Chief Counsel
(Passthroughs & Special Industries)

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subject: Generic Legal Advice - Effect of Hedging on Percentage Depletion Computation

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

Issues

1. For purposes of calculating the percentage depletion deduction under § 613, are gains or losses generated by hedging transactions undertaken to assure a minimum price for minerals gross income from mining under § 1.613-4 of the Income Tax regulations?

2. For purposes of calculating the percentage depletion deduction under § 613, are gains or losses generated by hedging transactions undertaken to assure a minimum price for minerals taxable income from the property under § 1.613-5?

Conclusions

1. Gains or losses generated by hedging transactions undertaken to assure a minimum price for minerals are not included within the calculation of gross income from mining under § 1.613-4.

2. Gains or losses generated by hedging transactions undertaken to assure a minimum price for minerals are not included within the calculation of taxable income from the property under § 1.613-5.

Background

Mining companies enter into price protection, or "hedging" transactions to ensure a certain level of stability for the selling price of their inventory of mine products. The term "hedge" means a counterbalancing transaction of a futures contract against an actual purchase or sale of a commodity or against a forward purchase or sale. Rev. Rul. 74-223, 1974-1 C.B. 23, 24. For example, an individual or company that buys or owns actual commodities would sell an equivalent amount of futures. If prices decline, the loss on inventories of the actual commodity is expected to be recouped, or offset, by a profit in the futures market. Conversely, should the price level rise, the loss on futures is expected to be offset by an increased value of the actual commodities owned. In either event, a loss on one side of the transaction would normally be offset by a profit on the other. Hedges, which eliminate speculative risks due to fluctuations in the market price of a particular commodity, are common trade practices and are generally regarded as a form of insurance necessary to conservative business operations. See Corn Products Refining Company v. Commissioner, 350 U.S. 46, 1955-2 C.B. 512 (1955).

The term "futures contract" means a contract to sell or purchase some fixed amount of the commodity at a future date at a fixed price. The periodic closing of these arrangements typically results in the recognition of ordinary gains or losses for tax purposes without actual extraction and sale of the hedged mineral commodity. Futures contracts may be closed by delivery or purchase of the mineral, supplies, or other property stipulated in the contract; purchase of a new contract covering the same amount of the property stipulated without delivery or receipt; or by paying or receiving the difference in contract price without delivery or receipt. Only a small percentage of futures contracts are closed by delivery or purchase of the property itself.

Your request stated that two contradictory issue positions and supporting arguments exist regarding the inclusion or exclusion of hedging gains or losses in the computation of the percentage depletion deduction under § 613. On returns with substantial hedging losses, some taxpayers have argued that such losses should not be included in the percentage depletion computation. In cases in which taxpayers have experienced hedging gains, some taxpayers have included the gains in the percentage depletion computation.

Code and Regulations

Section 611(a), in the case of mines, wells and other enumerated natural deposits, allows as a deduction in computing taxable income a reasonable allowance for depletion under regulations prescribed by the Secretary or his delegate.

Under § 613(a) the allowance for depletion under § 611(a) is based on a specified percentage of the gross income from the property. Such allowance for depletion may not exceed 50 percent of taxpayer's taxable income from the property. The term "gross income from the property" is defined in § 613(c)(1) as gross income from mining.

Section 1.613-4(a) provides that "gross income from mining" is that amount of income which is attributable to the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation. That section further provides that treatment processes considered as mining are mining processes, but that processes such as packaging and nonmining transportation are nonmining processes. Further elucidating the term, § 1.613-4(b)(1) provides that gross income from mining means "the actual amount for which the mineral is sold if the taxpayer sells the ore or mineral ... after application of only mining processes." It is thus proceeds received from the severance and subsequent sale of the ore or mineral which comprise "gross income from property" under section 613(a). § 1.613-4(b)(1)(i) and (ii).

Section 1.613-4(f)(1) defines mining as the extraction of ores or minerals from the ground, application of mining processes (as described in subparagraphs (2) through (6) of § 1.613-4(f)), and so much of the transportation of the ores or minerals from the point of extraction to the point where the mining processes are applied to the ores or minerals. Section 1.613-4(f)(2) defines mining processes narrowly based on the type of ore or mineral at issue, specifying and listing those processes. For example, §1.613-4(f)(2)(i)(a) defines mining processes, in the case of coal, as cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment. In each case, the term mining processes does not include any activity applied to the ores or minerals after loading the ore or mineral for shipment.

Section 1.613-4(f)(2)(iv) provides that the term "mining" does not include purchasing minerals from another. Accordingly, the processes listed in that section are mining processes only to the extent that they are applied by a mine owner or operator to an ore or mineral in respect of which the owner or operator is entitled to a deduction for depletion under § 611.

Section 1.613-5(a) provides, in general, that the term "taxable income from the property" means "gross income from the property," as defined in § 613(c) and § 1.613-4 less allowable deductions (excluding any deduction for depletion) which are attributable to the mineral processes, including mining transportation, with respect to which depletion is claimed.

Discussion

Gross income from mining is defined in § 1.613-4(b)(1) as "the actual amount for which the mineral is sold if the taxpayer sells the ore or mineral ... after application of only mining processes." Mining processes are narrowly defined in the regulations to include only specified actions. Further, even processes that would constitute mining processes if performed on ores or minerals extracted by the mine owner or operator, are not mining processes if performed on purchased ores or minerals, so that the sale of purchased ores or minerals would not provide the seller with gross income from mining. Thus, the Code and regulations narrowly define what constitutes gross income from mining, limiting that term to the amount received for the ore or mineral mined by the seller after the application of certain limited processes.

In general, the Service has described hedging transactions as a form of insurance. Rev. Rul. 74-223, 1974-1 C.B. 23; Rev. Rul. 72-179, 1972-1 C.B. 57. In Guthrie v. United States, 323 F.2d 143 (6th Cir. 1963), the court considered whether proceeds from another form of insurance, business interruption insurance, were included within gross income from mining. The court concluded that such proceeds were not includible within gross income from mining within the meaning of § 613(c), stating: “Had this taxpayer not had the foresight to carry business interruption insurance, its total gross income from mining would have been the amount it received for the coal it was able to mine and market, doing the best it could with its impaired operating ability. That this taxpayer avoided such consequences by carrying insurance does not make the insurance proceeds a part of the price which taxpayer received for its coal.” 323 F.2d, at 146. Similarly, the fact that a taxpayer has the foresight to trade in futures contracts to offset price fluctuations in the price of its ores or minerals does not make the proceeds of those transactions a part of the amount received for those ores and minerals.

Furthermore, gross income from the property is the amount of income directly attributable to the extraction and sale of ore or mineral from a specific mineral property. A hedging transaction is not a sale of ore or mineral itself, but, rather, sale of a right to the ore or mineral. Commissioner v. Covington, 120 F.2d 768 (5th Cir. 1941).

Thus, gains or losses generated by hedging transactions undertaken to assure a minimum price for minerals are not included within the calculation of gross income from mining under § 1.613-4.

Similarly, the term “taxable income from the property” is defined in § 1.613-5(a) as “gross income from the property,” as defined in § 613(c) and § 1.613-4 (i.e., gross income from mining), less allowable deductions (excluding any deduction for depletion) which are attributable to the mineral processes, including mining transportation, with respect to which depletion is claimed. Because taxable income from the property begins with gross income from mining and allows only those deductions attributable to mineral processes, the obvious intent of the regulations is to narrowly define taxable income from the property just as they narrowly define gross income from mining. Hedging transactions, as discussed above, are a form of price insurance. Insurance is not an allowable deduction attributable to the mineral processes, within the meaning of 1.613-5(a). Gains or losses from hedging transactions, or ”price insurance” are also not taken into account in computing taxable income from the property.

Thus, gains or losses generated by hedging transactions undertaken to assure a minimum price for minerals are not included within the calculation of taxable income from the property under § 1.613-5.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

I hope this is helpful to you. Please call (202) 622-3110 if you have any further questions.

CURTIS G. WILSON
Associate Chief Counsel
(Passthroughs & Special Industries)